CONCEPT PAPER: USE OF BONDING TO MITIGATE LOCAL UNITS OF GOVERNMENTS' PENSIONS AND RETIREES' HEALTHCARE (OPEB) VIA AN AUTHORITY
September 27, 2013

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BACKGROUND

Many Michigan local units of government have committed to fund defined-benefit pension and / or other post-employment benefit programs (e.g. OPEB as in retirees' healthcare, insurance, etc.) that they are now beyond their financial means. These two fringe benefit programs are frequently codified in collective bargaining agreements with pension plans being protected by the State Constitution.

Employees and retirees' are expecting pension and OPEB benefit payments upon retirement as committed to by the local unit of government, but in some fiscally distressed units this commitment could be abrogated through P.A. 436 of 2012 ('Emergency Manager Act') and / or Chapter 9 bankruptcy.

The City of Detroit's recent entry into Chapter 9 bankruptcy is bringing a whole new light on pensions and OBEB benefits commitments and the City's ability to now fund these commitments earned in prior years. Similar issues remain in many other local units of government under P.A. 436 (i.e. Pontiac, Flint and others). In fact, other local units of government not in P.A. 436 status are struggling to fund these commitments as they come due, let alone funding them in accordance with actuarial recommendations (particularly the OPEB benefits).

Detroit's pension and OPEB commitments are under review by the emergency manager and numerous reports of underfunding, unethical behavior by trustees and questionable financial transactions are being reported in the media on a daily basis. City officials refute these allegations. Only time and court actions will provide the taxpayers and employees of Detroit the ability to determine who is correct. The actions arising from the bankruptcy court will be instructive for all local units of government in Michigan.

Detroit's emergency manager is considering the unfunded actuarial accrued liabilities of the pension and OPEB plans as an unsecured City obligation. Recently, the emergency manager indicated that effective January 1, 2014 all new hires in Detroit will be under a defined contribution pension plan. The OPEB plan may be converted into a form of a defined benefit plan with monthly payments provided to retirees' that would secure healthcare from future exchanges. Detroit's OPEB issue remains unresolved.

While the City of Pontiac recently exited from P.A. 436, the pension plans are over-funding and for the most part, its OPEB plans are substantially unfunded. The resolution of the OPEB plan and annual amounts paid by Pontiac remain unresolved. Several court cases are pending. Legal bills are mounting in a City that that can ill afford scarce resources in a legal debate over funding OPEB. Pontiac is likely not alone in this business issue.

While most local units of government will fully fund *pension* contributions in accordance with an actuary's recommendation (as required by State statutes, the absence of which could lead to an emergency manager through one of several 'triggers' in P.A. 436of 2012), local units of governments' funding of *OPEB* contributions frequently have included only the *current* retirees' medical and other costs immediately due from retirees' medical procedures (often referred to as 'pay-as-you-go' funding). Paying only the retirees' medical bills as presented serves to increase the OPEB liabilities, weaken the fiscal health of the local unit of government and expose current employees and retirees to potential reductions in OPEB benefits in the future.

IMPACT OF THE FAILURE TO PROPERLY FUND

Unfortunately, when local units of government pay only the retirees' medical bills currently, the local unit has shorted the actuarially recommended contribution for the employee rights earned during the year for a benefit to be paid when the employee retires in the future. In fact, in doing so, the future unfunded obligation (often referred to as 'unfunded actuarial accrued liability' or unfunded AAL) increases as no assets are currently being set aside for current earned rights to be paid into the future upon retirement. With no assets in a trust fund, there is no investment income to offset future OPEB costs.

Defined benefit pension plans have long funded their future requirements; OPEB benefits more often than not have no assets behind the commitments made by prior public officials.

Using financial, demographic and fringe benefit assumptions, actuaries calculate the estimated obligation due in today's dollars (actuarial accrued liability) for both defined benefit pension and OPEB plans. In theory, if there were sufficient assets in a trust plan that equal the AAL, the plan is considered to be fully funded and no costs should be charged to future operating budgets for these programs. The AAL obligation is adjusted with each actuarial report for actual results that might have differed from the assumptions used in prior reports for financial, demographic and benefit matters. The differences are referenced as 'actuarial gains or losses' and will be factored into the annual require contributions in future years to eventually, over time, bring the plan to a fully funded status.

In addition, the actuary recommends an 'annual required contribution', or ARC, that should be made in the current year that has two basic components and is based upon the AAL status relative to the assets in the plan:

- **Normal costs** – normal costs represent the employees' fringe benefit rights earned, expressed in discounted dollars, for future medical costs during retirement by the employee. In essence and with the assumptions used by the actuary coming true into the future, the amount paid for normal costs, along with investment income earned in the future on the assets set aside, should be sufficient to pay future healthcare bills for employees upon retirement until death.

- **Actuarial Accrued Liabilities (AAL)** – the actuarial accrued liabilities represent the amounts owed to employees for prior employee service rendered discounted to today's dollars. In theory, if the trust assets equaled the AAL and the assumptions held true into the future, the assets would be sufficient to pay all future benefits earned for prior service with no future contributions being required from the local unit of government.

  When assets, as calculated by the actuary, exceed the AAL, there would be no future ARC payment required. Only when the assets are less than the ARC (an 'unfunded' position) would there be a future payment to reduce the unfunded AAL over the next several years through an ARC payment.

Local units of government, however, often pay only the 'pay-as-you-go' amount which is substantially less than the actuary's recommended ARC (particularly if no assets had previously been set aside for prior earned rights by employees). The difference between the ARC (which over time would ensure full funding of the defined benefit plan) and the 'pay-as-you-go' amount essentially increases the AAL from one period to the next. It is a form of an actuarial loss as the actuary expected the ARC to be paid. Year after year failures to fully the ARCs results in a compounding effect given lost investment income on assets that are never been set aside; the reverse is true if assets have actually been set aside.

As the unfunded AAL increases so does future ARC payments, even as the actual payments for medical care for retirees' may remain considerably less than the ARC payment (under a 'pay-as-you-go' approach). However, as the gap between the ARC and 'pay-as-you-go' amounts increases, it becomes increasingly more difficult for local units to ever fund the ARC out of their annual operating budgets. Replicate this over years of not properly funding the ARC and the unfunded AAL can become as high as $6.0 billion in Detroit's case and absolutely impossible to ever fund absent either the State or federal government providing grants to do so. The result will be reductions in retiree benefits earned and / or continued fiscal pressures on operating budgets into the future.

With rising costs in healthcare and local units not properly funding OPEB, 'pay-as-you-go' funding often creates substantial fiscal pressures on current programs (e.g. police, fire, EMS, etc.) as the retirees' medical benefits require current payment in today's operating dollars for services rendered many years ago. The effect of this budgetary issue is retirees' medical benefits must be paid even as the current employees earning rights in future medical benefits are deferred. Current operations suffer the loss as they continually get squeezed. Recent reductions in local units of government revenues have further exacerbated the fiscal distress. Somehow, the cycle of deferring costs into the future, particularly as the costs are increasing, has to be stopped – or, at a minimum, mitigated.

BONDING AS AN APPROACH

Issuing bonds as a means to address the presently unfunded AAL and to mitigate future annual required contributions for defined benefit pensions and / or OPEB fringe benefits may be one way to assist in controlling the these current and future benefit costs. P.A. 329 of 2012 was issued to do just that for individual local units of government.

In Oakland County, the issuance of certificates of participation in 2007 (a special debt instrument) and the refunding bonds just issued have been able to mitigate the cost of its OPEB fringe benefit by several hundred millions of dollars over the coming decades. The bonding approach for the remaining unfunded AAL provides assurances that the coveted AAA bond rating will be retained well into the future. Other local units may avail themselves of P.A. 329 of 2012 as well.

The use of bonds to fund presently unfunded actuarial accrued liabilities as a means to mitigate future ARC requirements is now possible with the recent legislation. In effect, the taxable bonds issued in such a transaction can presently be issued at a rate of between 3.7% and 4.7%, well below the actuarial assumption of pension and OPEB plans' long-term investment performance. The difference between the interest paid and the interest earned, over the long term, serves to mitigate the cost of funding the present unfunded AAL into the future.

Even as the local unit of government may address its pension and / or OPEB obligations by funding through bonds, future normal costs will not be mitigated in most instances with this approach. The bonding occurs as of a point in time and generally related to prior earned service rights. The normal costs arise from employees earning a right *in the future* and after the bonds have been issued. Rights earned for pension and / or OPEB benefits upon retirement by employee in future (e.g. requiring normal cost payments via an ARC) will remain a cost to be reckoned with regardless of the bonding for an unfunded AAL.

In many small to medium sized local units of government and even if they meet the minimum standards of an AA bond rating, some local units may be too small to avail themselves of this new financial opportunity for OPEB fringe benefits. Costs associated with consulting to determine feasibility, legal and actuarial services, and bond issuances fees may prove to be prohibitive or a simply a barrier for considering this approach. A potential solution may be using an organization such as Michigan Municipal Services Authority (MMSA) or another authority to provide these services.

STRUCTURE OF PROPOSAL

The use of an authority would enable the 'launch costs' (e.g. feasibility of bonding; legal; actuarial; and other costs) to be spread over multiple local units of government pooled within a single bond issue. These costs can be recovered through bond proceeds. Managing the bond proceeds through a trust on behalf of the local units of government would serve to help fund the costs incurred by the authority.

The transaction flows relating to the proposal to assist certain smaller local units of government in benefitting from Act 329 for bonding of presently unfunded pension and / or OPEB obligations is attached from an earlier concept paper supplied to the MMSA Executive Board. In order that this approach could be used to assist local units of government, several critical action steps must be performed not the least of which is to provide permissible legislation to do so and revise existing legislation as the Urban Cooperation Act and other related acts.

A brief description follows as outlined in the attached diagram depicting an OPEB arrangement (a similar approach would be feasible for pensions as well):

- The eligible local unit of government would petition to participate in the MMSA or similar authority. The eligibility criteria would have to be defined, but the targeted local unit of government group would be for the smaller local units with decent credit and some prior funding of the OPEB benefits. Bundling these smaller units into a single debt issue could spread the feasibility and issuance costs over a larger base of local units.

- MMSA or similar authority could approve entry into the program and along with several other local units. A bond issue would be developed with one or more local units participating. The bond would be recordable on the local unit's financial statements, but the related pension and / or OPEB obligation would then be removed. The 'soft' liability of an unfunded AAL has been converted to a 'hard' liability and in doing so, should be considered a 'credit positive' transaction for the local unit of government. Bonding needs for the local unit of government for unrelated programs should reap the benefit of a better bond rating.

  Any bonding issued through this approach would be required to be approved by the Michigan Department of Treasury.

  The MMSA or similar authority would help local units through the bonding process with the expertise retained centrally, including determining financial feasibility, actuarial needs and / or legal needs. These costs would become part of the underlying bond issuance costs. Over time and with experience, the authority's costs should be reduced over those costs borne through an individual debt issue.

- The bond proceeds would flow into a Voluntary Employee Benefit Association trust fund (VEBA, either directly or via the MMSA or similar authority). The VEBA would be an irrevocable trust fund whereby the only expenditures permitted from that VEBA trust would be:

  - Payment of retirees' medical expenses if self-insured, premiums paid to an insurance company or premiums paid to purchase future annuities.

- Administrative expenses paid to the MMSA or similar entity as a service fee for operating the program.

- A provision for a 'risk pool' as an offset against potential declines in the investment market. Alternatively and in the case of Oakland County's annuitized pension benefits in a defined contribution plan, a 1% service fee is charged to ensure that a minimum payment is made for pension payments. Perhaps some similar arrangement could be arranged with an outside insurance or investment management firm to mitigate investment performance risk.

- Semi-annually, the local unit would pay the debt service (e.g. bond principal and interest) to the MMSA or similar authority. In turn, the MMSA or similar entity would pay the bondholders.

- Likely, the investment pool would be co-mingled such that the VEBA trust would be a multiple-employer, cost-sharing program (similar to the Michigan Public Services Employees Retirement System – e.g. schools pension plan). If the arrangement under this proposal were to be accepted through legislation, there are several advantages to the State:

    - It continues to help local units of government resolve a very difficult fiscal issue that, absent any State or federal government funding, will continue to plague the State's and local units' financial stability.

    - The movement of the responsibility to the MMSA or similar authority could permit the exclusion of these operations from the State's comprehensive annual financial report.

    - Finally, it could provide current employees and retirees the knowledge that their medical benefits are should the local unit of government fiscally falter.

    - Because of the potential interception of State distributions in the event of the failure of a local unit of government to fund debt service to the MMSA or similar authority, the bond rating may achieve an AA or better backing even as several of the local units of government within the bundled bond would be unable to do so. While recognizing that some local units of government do not receive State distributions, the enhanced feature of interception would permit additional local units of government struggling with the payment of these pension and particularly OPEB benefits to avail themselves of this approach to mitigate their future operating costs.

BENEFITS TO A POOLED APPROACH VIA BONDS

The benefits to a pooled approach via bonds would include:

- A single entity would be able to assist smaller local units of government in securing bonded debt that might otherwise be unavailable to them given their operating size, credit rating and other business issues. These local units would then be able to avail themselves of the present low bond interest rates serving to reduce future operating costs associated with the pension and / or OPEB benefit programs.

- The benefits in the MMSA or similar authority would minimize the future fringe benefit costs for the following reasons –

    - The investment income (long-term rates of 7% to 8%) should be able to be used, over the interest rates of under 4.5%, such that the differential funds at least a portion principal payments required, returns a small amount of administrative fee to the MMSA or similar authority and provides security to the retirees' that their future retirement benefits will be honored.

    - The current annual required contribution is most often amortized at no greater than a 30-year term in accordance with generally accepted accounting principles. If the debt maturity period were limited to 20 years by legislation, the local unit would avoid paying the financing costs of the last 10 years today – or, longer if they are using a pay-as-you-go funding method.

      In Oakland County's bonding for the OPEB unfunded AAL, the reduction of the 10-year term as part of the 2007 certificates of participation debt issue provided no less than $100 million in reduced interest payments over the 20-year term.

    - The bond rating agencies should look on this approach as 'credit positive' as the local units move a 'soft' liability into a 'hard' liability and solve what is now a 'negative' impact on their local unit's bond rating. The Detroit emergency manager's plan under consideration by the bankruptcy court may exacerbate local units of government credit ratings depending upon the outcome of the court action. Bond rating agencies are under greater pressures than ever to review the use of 'pay-as-you-go' approach related to the unfunded AAL. Failing to resolve this funding approach may adversely impact a local unit of government's bond rating.

      By retaining or even improving the bond ratings of local units of government, infrastructure projects and other bonding needs are reduced and the taxpayers served through a fiscally responsible government.

- This bonding proposal could very well help to avoid several local units from entering emergency management. In each of the local units presently under an emergency manager operation, the unfunded AAL for OPEB are staggering (Detroit - $6.0 billion; Pontiac - $380 million; Flint - $800 million; etc.). A recent study by the Michigan State University cited that local units of government had over $13 billion in unfunded AAL relating to OPEB commitments to employees and retirees.

  In Detroit's bankruptcy, it is entirely likely that employees may never see the promised OPEB benefits in retirement and retirees may be forced to absorb substantial medical costs at a time when their income is likely fixed. Similar reductions of benefits to employees and retirees are likely in other local units of government (particularly those in emergency manager status) if the Detroit emergency management is able to reduce promised OPEB benefits.

- The multiple-employer employer cost-sharing program would allow smaller local units to spread their risk of adverse healthcare, investment and demographic losses over a larger pool of resources.

- The assets held in a VEBA or pension trust likely would be protected from future bankruptcy as the assets are comingled with other local units outside of the individual local unit's bankruptcy proceeding.

RISKS TO A POOL

The risks to a pool would include:

- The most obvious risk is a reduction in the investment portfolio value such that the amount of benefits to be paid could be jeopardized and could open additional funding requirements of local units beyond the original debt service payments required. This particular risk could be greater for an individual local unit than one in a pool with other local units.

  The risk can be mitigated by providing a 'market valuation pool' (essentially an overfunding position) as more local units of government enter the program. Use of a guaranteed annuity (with a slight reduction in investment income) could also be used to mitigate investment market risk as an alternative program for pension plans and perhaps OPEB.

  And, while markets may decline, they also go up. Four years ago, the investment market was at all-time highs. For several years later, the market had declined by over a third. Now, the market is nearing the same highs that existed before the market declined arising from the Great Recession. The investment performance of an OPEB (or the proposed pooled plan created through bonding) is of a *long-term nature*, not single year increments, and sufficient assets should remain in the plan to enable that plan to recover from short-term investment losses.

- The 2010 federal health insurance program has introduced uncertainty of future coverage and healthcare cost increases in this industry. The rules and regulations are currently being drafted for a national healthcare program that launches on January 1, 2014, less than 3 months away. Some administrative issues are beginning to manifest themselves in the launch of the full 2010 healthcare program that gave rise to delaying those portions of the plan for a year.

  Economic increases for healthcare programs have generally exceeded the national consumers' price index in the past, but these increases have been incorporated within the actuarial assumptions used in calculating the annual required contributions and the AAL for all OPEB plans. As such, the AAL and ARC reflect such increases and would be factors in the consideration of the sizing of the debt.

  One means of controlling the costs of healthcare increases is through the closing of the defined pension and / or OPEB plan to new hires and fixing the level of benefits upon closing. To a large extent, P. A. 329 of 2012 accomplished this task as a prerequisite of bonding for the unfunded AAL. Standardizing the benefits to be provided through MMSA or similar authority and limiting the healthcare options could also serve to mitigate costs. Finally, competitive bidding of the healthcare providers would assist as well.

- The program results in a catastrophic loss involving a retiree for health insurance purposes. This particular issue could be resolved through stop loss insurance by claim.

- The closing of a pension and / or OPEB plan results in a change in the underlying assumptions used by the actuary such that the actuarially- calculated annual required contribution often increases over the short-term. The increase in contribution requirements is temporary and at roughly 6 to 10 years actually would be reduced from levels otherwise funded using an actuary's recommended contribution. It is likely that the increased short-term losses would be offset through the debt service levels, but this analysis would have to be performed on a local unit by local unit basis.

- While the bond debt service on financing of the unfunded AAL is less than that absent the bonding, this approach addresses only one component of the annual required contribution. Normal costs, however, are generally unaffected by the borrowing (unless, for example, the pension and / or OPEB plan is over-funded) and will continue on into the future. Proper fiscal considerations must be undertaken in understanding the impact of the borrowing on future operating budgets on a local unit by local unit basis. Calculations using an actuary and potentially an outside financial consultant are critical to assess the *future* impact on budgets after a bond issue has been entered into.

Ultimately, there may be a requirement to periodically review the need for supplemental funding from the local units of government but this should be considered a 'last resort' action when other means of solving what then would be a fiscal issue of the authorities' pension and / or OPEB plan.

BUSINESS ISSUES

Issues and matters to be determined in the use of MMSA or a similar authority:

- Obviously, legislation must be drafted, passed and signed into law. Several other existing laws may need to be amended such as the Urban Cooperation Act.

- The pension and retirees' medical programs might require a standardized package (or packages) such that the fringe benefit administration could be minimized. Determining what would be a reasonable package(s) could be initially difficult. Likely, the actual pension and / or healthcare program would be administered by a third-party entity depending upon the nature of the fringe benefit program (e.g. self-insured, insured, etc.).

- The IRS status of the VEBA trust or pension trust would have to be secured.

- The MMSA or similar authority would need to secure a bond counsel, financial advisor and an actuary to run several 'what if' analyses on potential local units' information for those units wanting to participate after the legislation is passed.

  Particular care must be taken to ensure that the local unit's new debt service payment, along with normal costs, would be able to be funded in the future. The financial advisors would have to work with local management to assess the return on investment that a local unit might enjoy from this program.

- Because this new pension and / or OPEB plan would be offered to employees in bargaining groups, likely a labor attorney would be required to work through the details locally of these efforts. The local unit's public officials and labor groups need to assess the changes in the OPEB plan through the MMSA or similar authority would be traded for the assurances that the benefits earned throughout their careers would be secured through this arrangement.

- The MMSA or similar entity would have to determine the size of the local unit that would be eligible for the program. Entities in emergency manager status would be excluded and those with sizable unfunded pension and / or OPEB obligations likely would have such a weak bond rating that it would be impossible to secure an appropriate interest rate in the issuance of debt. Likely, the typical local unit that could avail themselves of this program would be one of a AA rating or slightly lower, with decent fiscal controls, substantially funded pension or partially funded OPEB plans and a progressive management and labor willing to enter into this transaction.

- As a condition of acceptance, the OPEB program would be closed. PA 329 of 2012 already addresses this requirement. The new hires for OPEB would be included in a Health Savings Account (defined contribution) plan. Similarly, the PA 329 of 2012 requires that the local unit open a defined contribution pension plan for new hires for as long as the bond is outstanding. Future changes in benefits for the closed plan would have to be controlled if not eliminated.

OTHER

A recently-established Local Government Task Force is discussing recommendations for consideration by the State Legislature. One of the items on a draft listing for consideration by the State Legislature is the development of a centralized authority pool of resources necessary to assist local units of government in solving their OPEB funding issues. While this concept paper is not endorsed by the Local Government Task Force, it is hopeful that this paper can be used by the State Legislature in an effort to assist local units of government.